After the storm

The new economic landscape will be grim unless policymakers act to foster growth.

Illustration by Jon Berkley

In the political dictionary he first published in 1968, William Safire, who died on September 27th, devoted an entry to the word “normalcy”. The term was made popular by Warren Harding, campaigning for America’s presidency in the wake of the first world war. It was inescapable after the terrorist attacks of September 11th 2001. Normalcy is what people call normality when they no longer take it for granted. No surprise, then, that the word reappeared in the communiqué released by the leaders of the G20 group of big economies after their Pittsburgh summit on September 24th-25th. After the wrenching economic crisis of the past year, people crave stability and predictability—in short, normalcy. But how far off is it? And what will a “normal” world economy look like after the biggest financial bust since the Depression?

The new normal

Glance at share prices or short-term growth forecasts and you might feel comforted. Output has stopped shrinking in all the world’s big economies. In its latest forecasts the IMF reckons global GDP will expand by 3.1% next year, 1.2 percentage points faster than it forecast in April. Global stockmarkets have rallied by 64% since their trough. Corporate finance, once frozen, is thawing fast. Bearish analysts are once again having to justify their pessimism.

Yet closer inspection suggests caution. Despite a welcome return to growth, the world economy is far from returning to “normal” activity. Unemployment is still rising and much manufacturing capacity remains idle. Many of the sources of today’s growth are temporary and precarious. The rebuilding of inventories will not boost firms’ output for long. Across the globe spending is being driven by government largesse, not animal spirits. Massive fiscal and monetary stimulus is cushioning the damage to households’ and banks’ balance-sheets, but the underlying problems remain. In America and other former bubble economies, household debts are worryingly high, and banks need to bolster their capital. That suggests consumer spending will be lower and the cost of capital higher than before the crunch. The world economy may see a few quarters of respectable growth, but it will not bounce back to where it would have been had the crisis never happened.

That realisation alone should temper some of the optimism buoying financial markets. But the prospect of a “new normal” (a phrase popularised by Mohamed El-Erian, the boss of Pimco, a fund manager) still spans at least two distinct possibilities. One is that the world economy returns roughly to its pre-crisis rate of growth, without regaining the ground lost. That, the IMF points out, is what happens after most financial crises. The second, more depressing

possibility is that growth stays at a permanently lower rate, with investment, employment and productivity growth all feebler than before.

The difference between these outcomes is huge, as our special report on the world economy points out. Persistent damage to economies' growth potential would result in a darker future of sluggish income gains and diminished expectations. That, above all, is what policymakers must avoid. To do so, they must pull off several tricky manoeuvres: shoring up demand now without wrecking the public finances; containing unemployment without inhibiting the shift of workers from old industries to new ones; and, more than anything else, fostering innovation and trade, the ultimate engines of growth.

Shoring up demand is the most urgent task. It is no secret that global spending must be rebalanced: indebted American consumers must cut back, while thrifty countries should spend more and save less. In China this means a stronger currency, bigger social safety-nets and an overhaul of subsidies to increase the share of national income going to workers. Germany and Japan need structural reforms to boost spending, especially in services. What has long been lacking is the political will—and here the G20 seemed to make progress. The Pittsburgh communiqué promised to subject members' economic policies to "peer review". These reviews may prove toothless, but the commitment to them is a step forward.

Private spending in surplus economies will not soar overnight. The world economy will rely more on governments for longer than anyone would like. Premature fiscal repairs could jeopardise the recovery, as America learned in 1937 and Japan rediscovered 60 years later. Governments must eventually fix their balance-sheets, but only when the private sector is strong enough—and it must be done in a way that boosts economies' growth potential. The bulk of the adjustment should come from spending cuts. Where revenues must rise, taxes on consumption or carbon are better than those on wages or profits.

Out with the old

Governments must also combat joblessness without ossifying their labour markets. High unemployment can do lasting damage, as people lose their skills or their ties to the world of work. This danger justifies efforts to slow lay-offs or encourage hiring. But not all such remedies are equal. Some of the most popular of today's schemes—such as paying employers to cut hours rather than jobs, as in Germany—try to preserve the labour force in aspic. Economies must be free to reinvent themselves and allow thriving industries to replace ailing ones.

The path of productivity growth will determine the nature of the new normal more than anything else. In the rich world, innovation sets the pace. Elsewhere, trade is often more important. Both are now under threat. Cash-strapped companies are skimping on research and development. Emerging economies are having to rethink their reliance on exports for growth. Both rich and poor governments will be tempted to intervene. They should avoid cosseting specific industries with subsidies or protection. Allowing market signals to work will do more to boost productivity than cack-handed industrial policy.

Add all this up and the difficulties are formidable. "A sense of normalcy should not lead to complacency," the G20 communiqué says, with both rhyme and reason. The storm has passed. But policymakers have a lot to do—and a lot of mistakes to avoid—if they are to make the best of the recovery.

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